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*Consulting Economists*

Testimony of

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Before the

Copyright Royalty Board

Washington, D.C.

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**TABLE OF CONTENTS**

	<u>Page</u>
Qualifications.....	1
Purpose of Testimony .....	1
Summary of Key Findings .....	2
Discussion.....	3
I. Costs .....	3
A. Royalties .....	3
1. Mechanical Royalties .....	3
2. Artist Royalties .....	5
B. Advances and Recording Costs.....	7
C. Direct Marketing.....	9
D. Manufacturing .....	11
E. Distribution.....	13
F. Overhead .....	15
G. Summary .....	17
II. Revenues .....	18
A. Net Sales Revenue .....	19
B. Net License Income .....	20
III. Comparison of Costs and Revenues .....	21

**LIST OF FIGURES**

	<u>Page</u>
Figure 1: Mechanical Royalties .....	4
Figure 2: Mechanical Royalties as a Percent of Net Sales Revenue .....	5
Figure 3: Artist Royalties .....	6
Figure 4: Artist Royalties as a Percent of Net Sales Revenue .....	7
Figure 5: Advances & Recording Costs .....	8
Figure 6: Advances & Recording Costs as a Percent of Net Sales Revenue .....	9
Figure 7: Direct Marketing Costs.....	10
Figure 8: Direct Marketing Costs as a Percent of Net Sales Revenue.....	11
Figure 9: Manufacturing Costs.....	12
Figure 10: Manufacturing Costs as a Percent of Net Sales Revenue .....	13
Figure 11: Distribution Costs.....	14
Figure 12: Distribution Costs as a Percent of Net Sales Revenue.....	15
Figure 13: Overhead Costs.....	16
Figure 14: Overhead Costs as a Percent of Net Sales Revenue .....	17
Figure 15: Total Costs.....	18
Figure 16: Net Sales Revenue.....	19
Figure 17: Net License Income .....	20
Figure 18: Net Sales and License Revenue and Total Costs.....	22

**Testimony of Linda McLaughlin**

**Qualifications**

I am an economist and a Senior Vice President at National Economic Research Associates, Inc. (NERA). I have conducted economic analyses of the entertainment and media industries for over twenty-five years. I have analyzed markets for music rights and other issues in radio, recorded music, motion pictures, and broadcast, cable and satellite television. I have also analyzed costs and revenues in these industries, and aggregated data for individual companies in the same industry. A more detailed statement of my educational background and qualifications is attached as Appendix 1.

**Purpose of Testimony**

The purpose of my testimony is to show the nature and amount of the expenses incurred, as well as the revenue generated, during the 15-year period 1991-2005 by the record labels affiliated with the major U.S. record companies.<sup>1</sup> At my direction, the data underlying this testimony were provided to me by each of the four largest record companies, known as the "majors." These companies are EMI Group, Sony BMG Music Entertainment, Universal Music Group and Warner Music Group.<sup>2</sup> I

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<sup>1</sup> 2006 data are not yet available.

<sup>2</sup> The music labels of BMG Entertainment and Sony Music U.S. operated separately until August 2004, when they were combined into Sony BMG Music Entertainment. BMG Entertainment and Sony Music U.S. each provided data for their respective labels for the 1991-2003 period. Sony

aggregated the data I received from the majors to produce the tables contained in RIAA Ex. M-201-DR entitled "Major Record Companies, Summary of Revenues and Costs for Domestic Sales." The data in this exhibit cover label revenues derived from record sales, the costs related to those sales, and revenues from the license of sound recordings.<sup>3</sup> (The term "record sales" refers to sales of several types of sound recordings, including singles and albums recorded on CDs, cassettes and LPs and music videos, as well as digital sales.)

### **Summary of Key Findings**

As set forth in more detail below, the costs incurred by the major record labels increased each year from 1991 through 1999. Since then, costs decreased in each year except 2005, when there was a small increase. (See Figure 15.) Net sales revenue followed a somewhat similar pattern, with increases each year from 1991 through 1999, decreases each year from 2000 through 2003 and then increases in 2004 and 2005. (See

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Footnote continued from previous page

BMG provided data for Sony and BMG separately in 2004. PolyGram, part of Universal Music Group since 1999, operated separately during the 1991-98 period. Universal provided PolyGram data in the pre-acquisition period.

<sup>3</sup> The revenues and expenses shown in my report are those of the major labels primarily for the sound recordings produced by those labels. In most cases, manufacturing and distribution expenses of the major labels are payments from the labels to affiliated entities that perform the manufacturing and distribution activities and cover the affiliated entities' costs and profits. The data do not include other income/expense, such as net income/expense of joint ventures and reorganization expenses.

Figure 16.) From 1991 to 2005, the percentage of industry revenues paid in mechanical royalties has increased. (See Figure 2).

## **Discussion**

### **I. Costs**

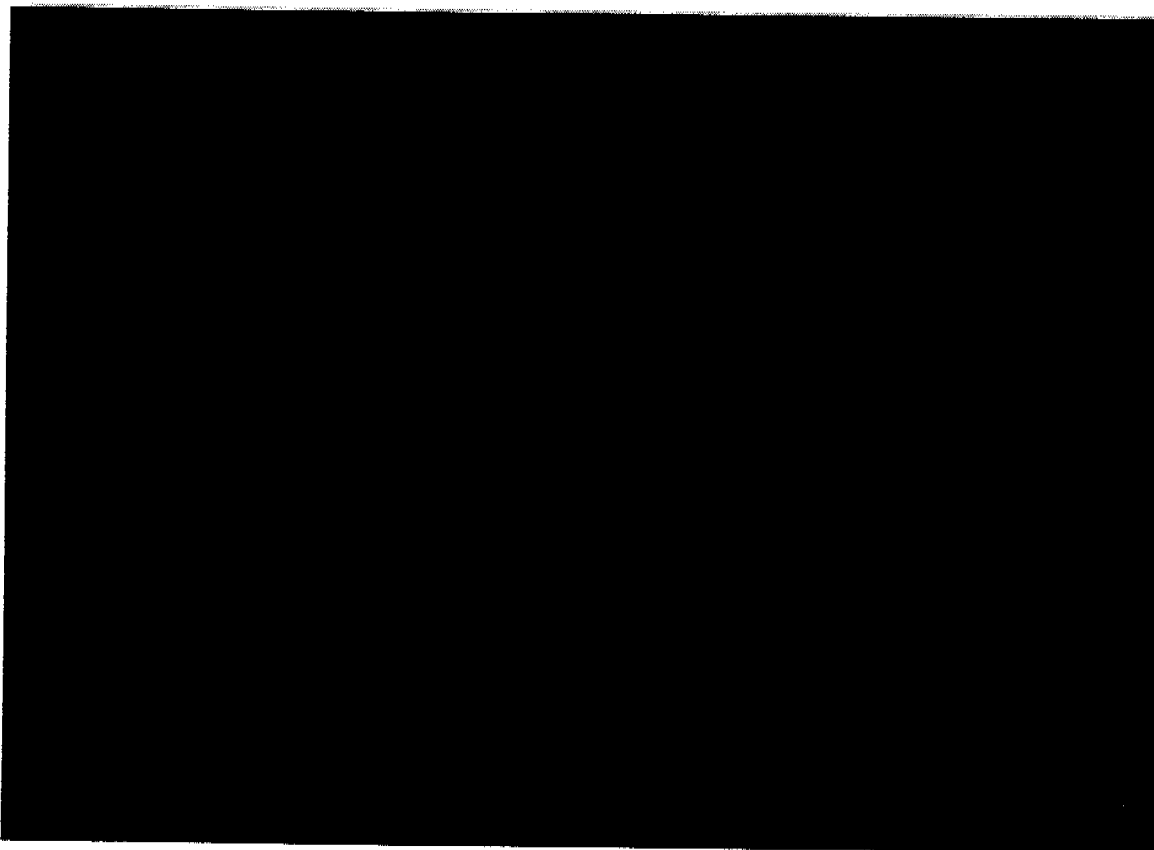
In this section, I provide data on the various costs for the major record labels for the years 1991-2005, including mechanical royalties, artist royalties, advances and recording costs, direct marketing, manufacturing, distribution, and overhead.

#### **A. Royalties**

##### **1. Mechanical Royalties**

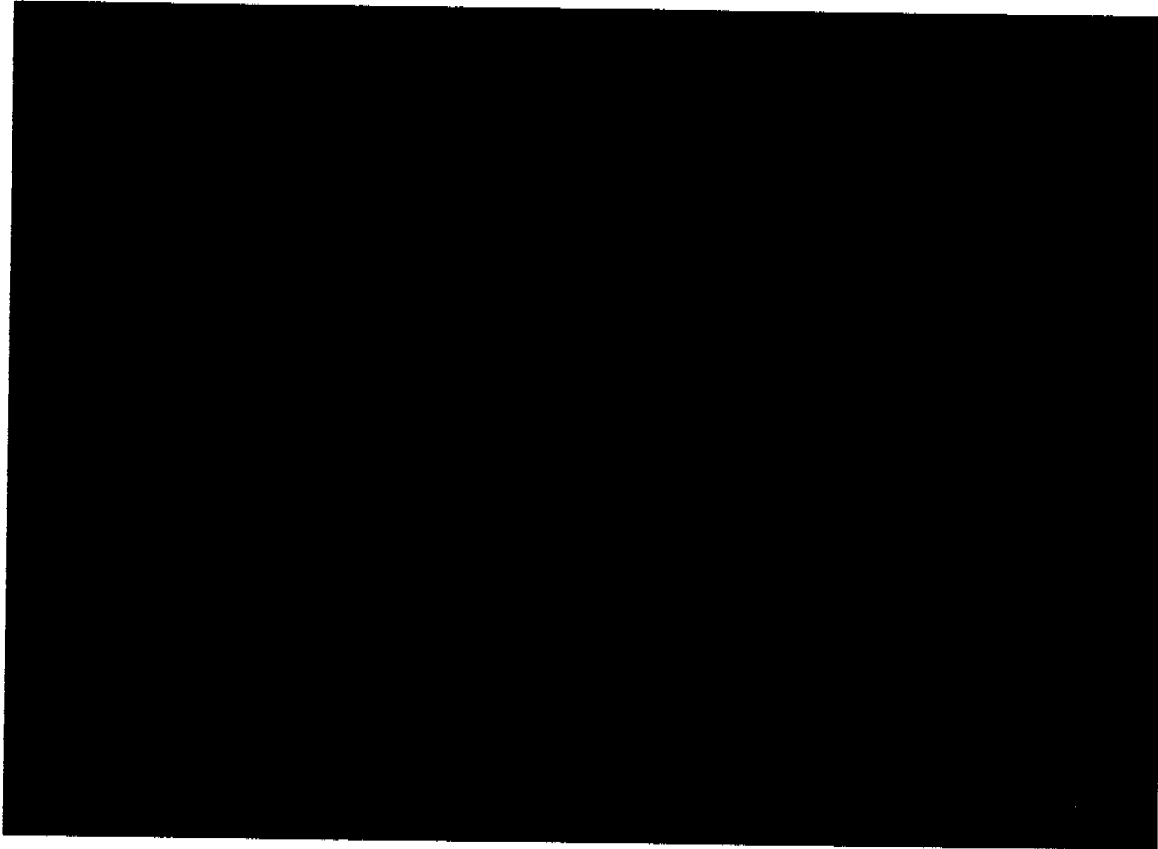
The term “Mechanical Royalties” refers to royalties paid by the major labels to music publishers on behalf of songwriters and publishers for U.S. record sales. These royalties are paid for the “mechanical license” to reproduce and distribute the musical works underlying sound recordings.

The mechanical royalties paid by the major labels collectively during each of the years 1991-2005 are shown in Figure 1.



**Figure 1**

As RIAA Ex. M-201-DR and Figure 1 illustrate, the major labels spent a total of [REDACTED] on mechanical royalties during the years 1991-2005, or an average of [REDACTED] per year. As shown in Figure 2 below, mechanical royalties ranged from [REDACTED] to [REDACTED] percent of the labels' net sales revenue.



**Figure 2**

## 2. Artist Royalties

The term "Artist Royalties" in RIAA Ex. M-201-DR refers to royalties earned by the featured artists<sup>4</sup> as well as health and pension plan payments to the American Federation of Musicians ("AFM") and the American Federation of Television and Radio Artists ("AFTRA"), unions that collect such payments on behalf of their members, who generally are

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<sup>4</sup> Some of the royalties earned by the artists may be used to repay artist advances and certain expenses of making the recordings and promoting them, which were initially paid by the record labels. These other expenses, discussed below, are shown net of any repayments. The remainder of the artist royalties earned are paid to the artists by the record labels.



studio musicians and vocalists. Royalties here include only payments for record sales in the United States.

The artist royalties paid by the major labels collectively during each of the years 1991-2005 are shown in Figure 3.



**Figure 3**

As RIAA Ex. M-201-DR and Figure 3 illustrate, the major labels spent a total of [REDACTED] on artist royalties during the years 1991-2005, or an average of [REDACTED] per year. As shown in Figure 4 below, artist royalties ranged from [REDACTED] to [REDACTED] percent of the labels' net sales revenue.

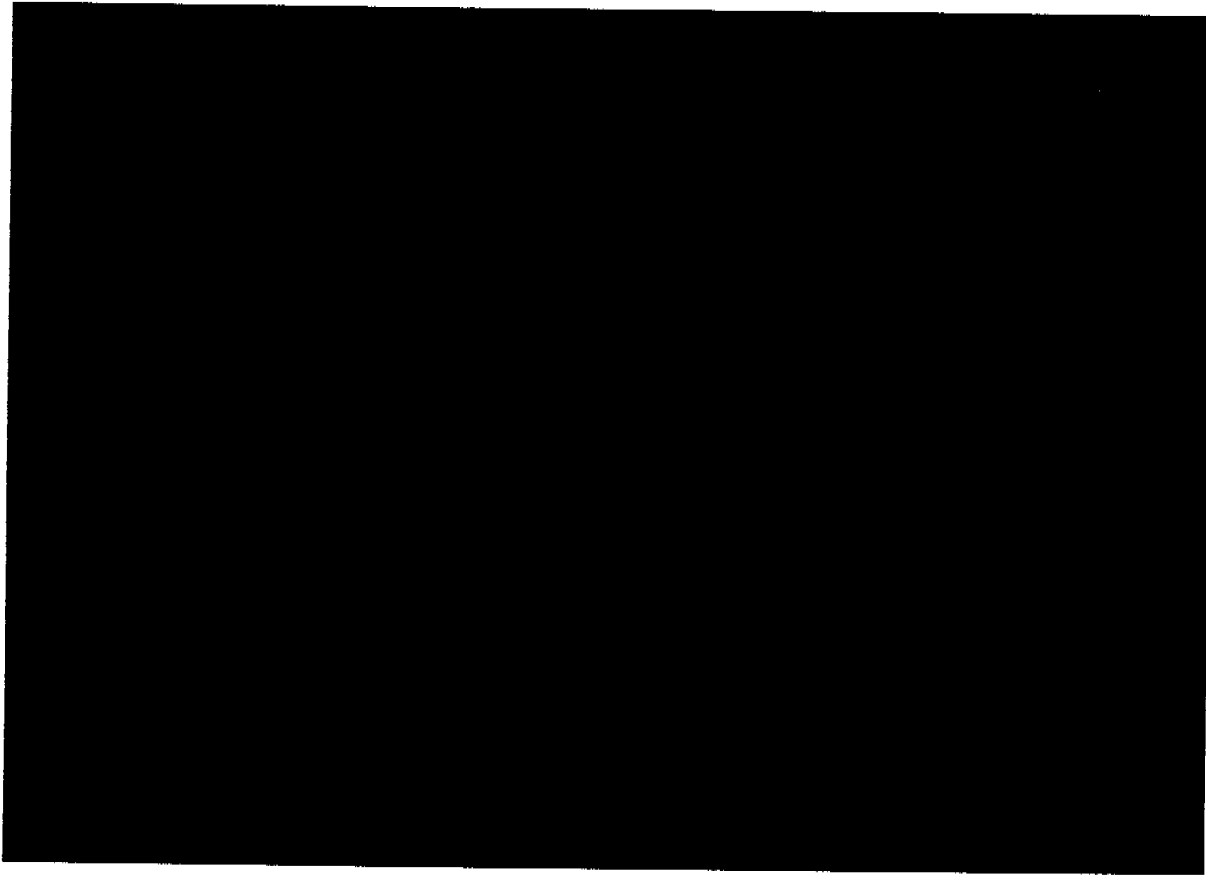


Figure 4

**B. Advances and Recording Costs**

The term "Advances" refers to advances that are paid to artists and that are not likely to be "recouped," i.e., recovered from artist royalties. It does not include advances that have been recouped. The term "Recording Costs" refers to recording costs that are paid directly by the record label and that are not recouped.<sup>5</sup>

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<sup>5</sup> Advances and recording costs that have been recouped are included in artist royalties.

The advances and recording costs paid by the major record labels collectively during each of the years 1991-2005 are shown in Figure 5.

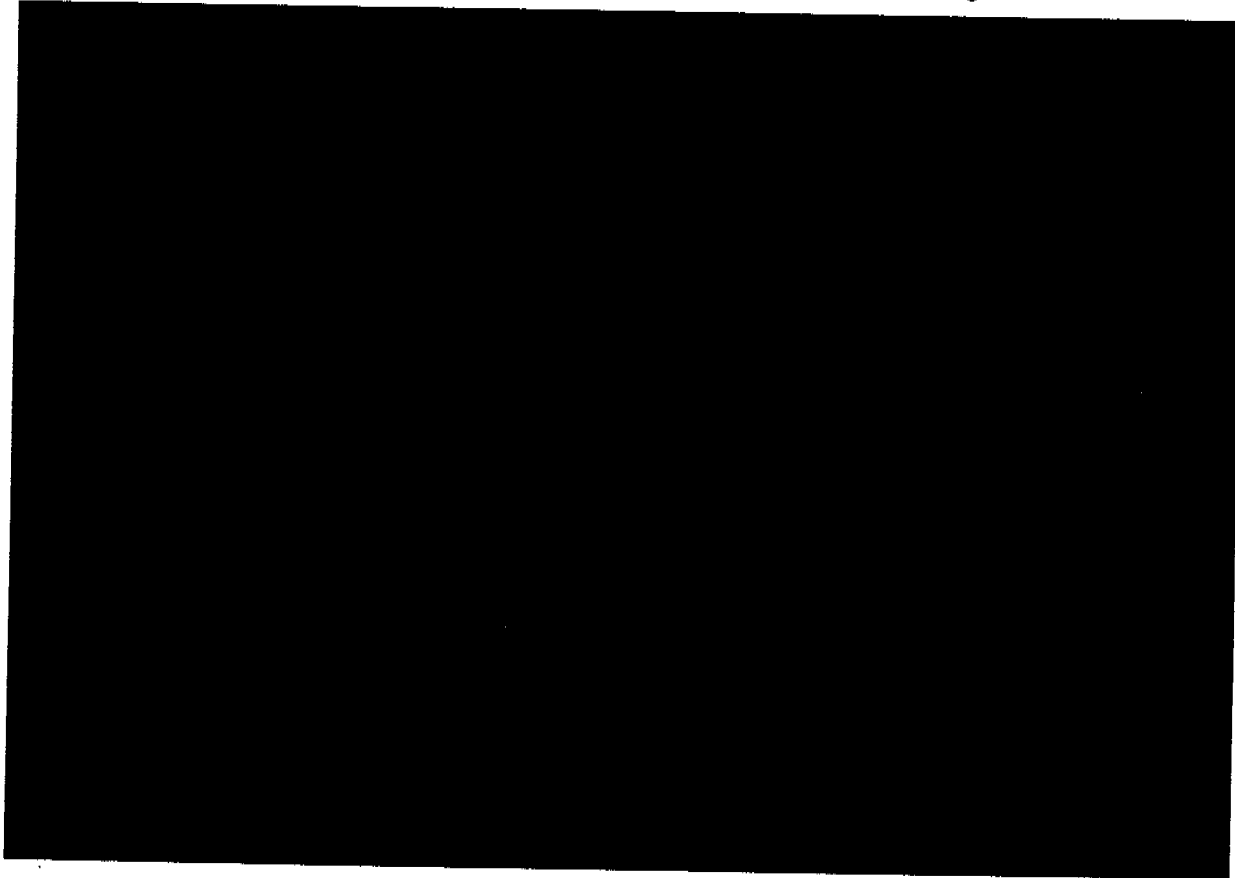
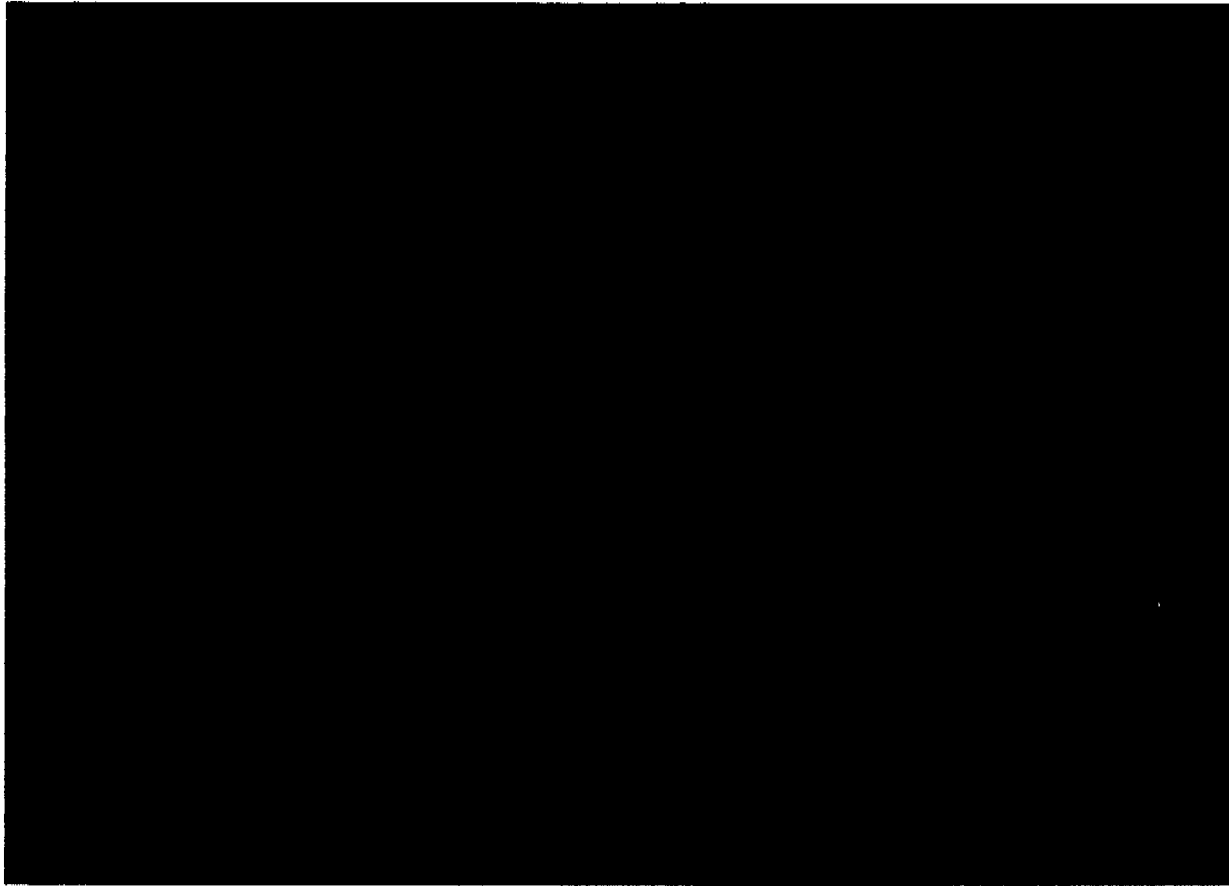


Figure 5

As RIAA Ex. M-201-DR and Figure 5 illustrate, the major record labels spent a total of [REDACTED] on advances and recording costs during the years 1991-2005, or an average of [REDACTED] per year. As shown in Figure 6 below, advances and recording costs ranged from [REDACTED] to [REDACTED] percent of the record labels' net sales revenue.



**Figure 6**

**C. Direct Marketing**

The term "Direct Marketing" includes costs from a number of advertising and promotional activities undertaken by the record label. It includes record label advertising, video costs and tour support.<sup>6</sup> It also includes payments to retailers for advertising and in-store promotion, and other promotional activities.

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<sup>6</sup> Marketing costs, such as tour support, that have been recouped from artists are included in artist royalties. Costs that are not recoupable or have not been recouped are included in direct marketing costs.

The direct marketing costs paid by the major record labels collectively during each of the years 1991-2005 are shown in Figure 7.

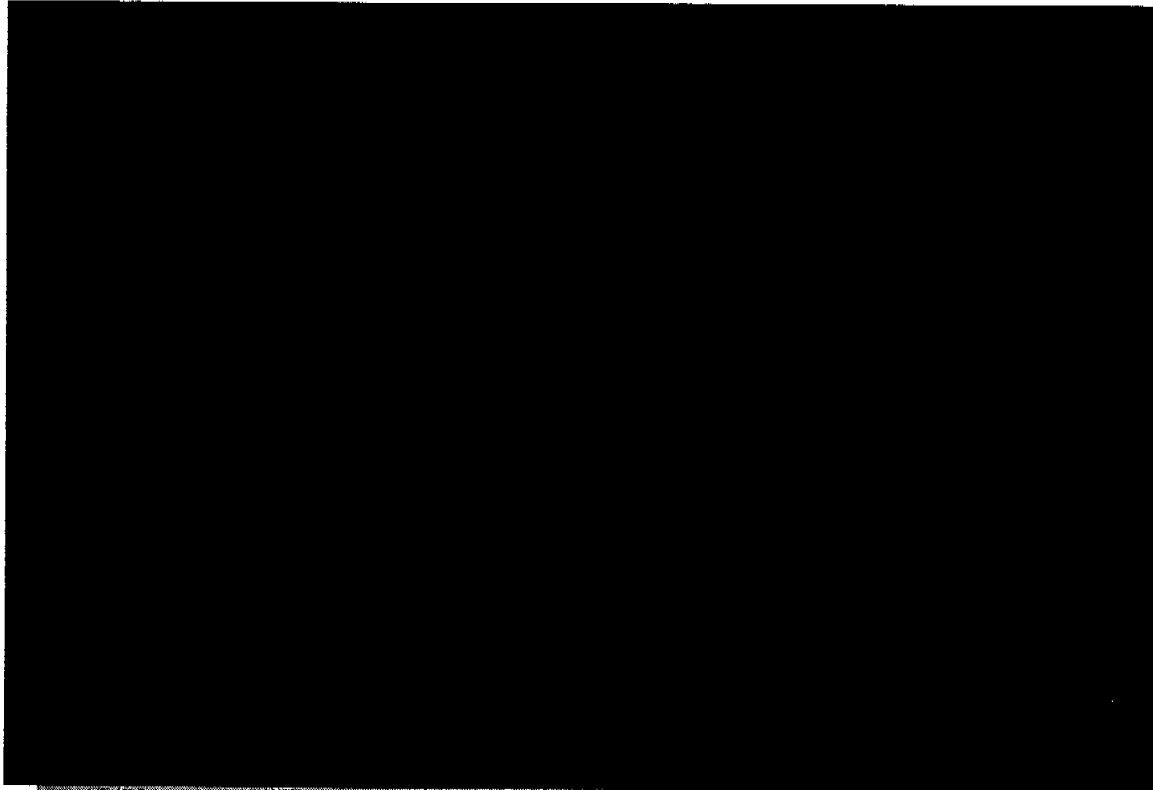


Figure 7

As RIAA Ex. M-201-DR and Figure 7 illustrate, the major record labels spent a total of [REDACTED] on direct marketing costs during the years 1991-2005, or an average of [REDACTED] per year. As shown in Figure 8 below, direct marketing costs ranged from [REDACTED] to [REDACTED] percent of the record labels' net sales revenue.

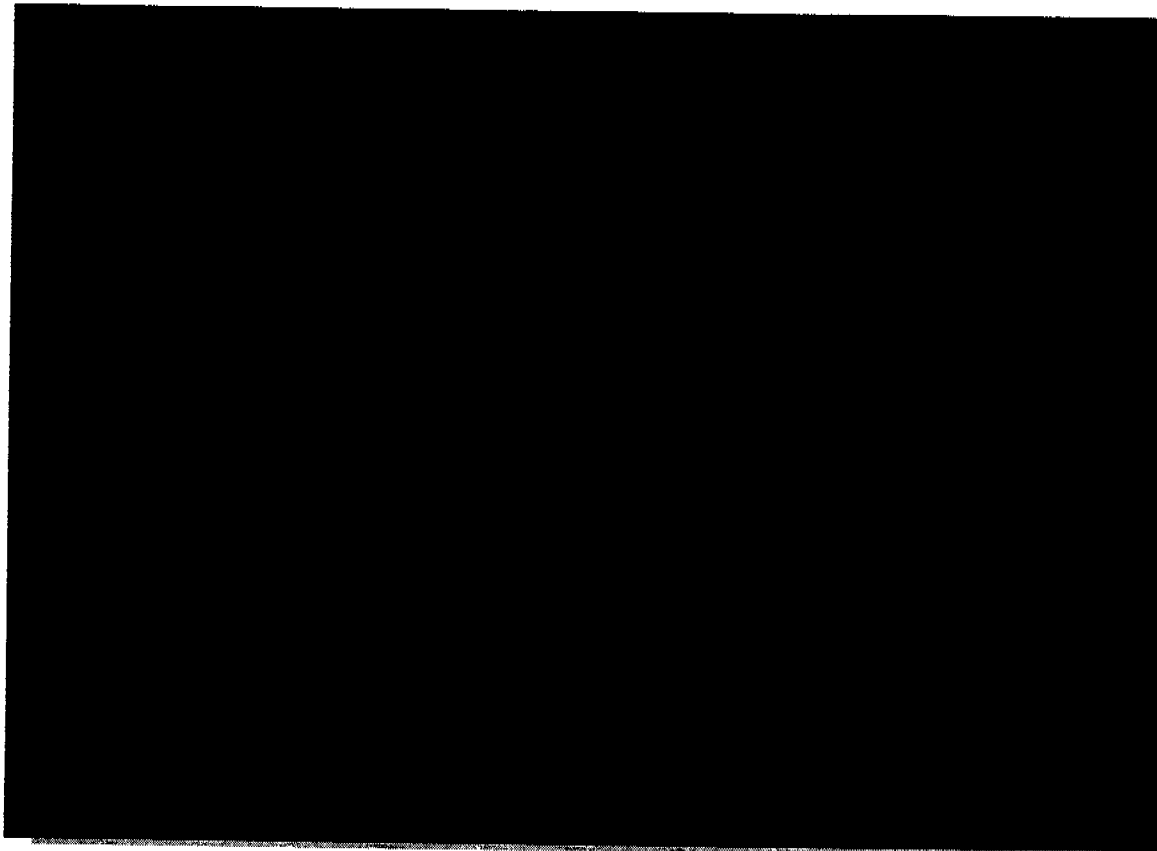


**Figure 8**

**D. Manufacturing**

The term “Manufacturing” refers to the record labels’ costs of manufacturing sound recordings in various formats such as CDs and cassettes. It also includes the costs of packaging, liner notes and cover art. The value of scrapped, unsaleable product is also included in this category. This value is generally referred to as “obsolescence.”

The manufacturing costs paid by the major record labels collectively during each of the years 1991-2005 are shown in Figure 9.



**Figure 9**

As RIAA Ex. M-201-DR and Figure 9 illustrate, the major record labels spent a total of [REDACTED] on manufacturing costs during the years 1991-2005, or an average of [REDACTED] per year. As shown in Figure 10 below, manufacturing costs ranged from [REDACTED] to [REDACTED] percent of the record labels' net sales revenue.



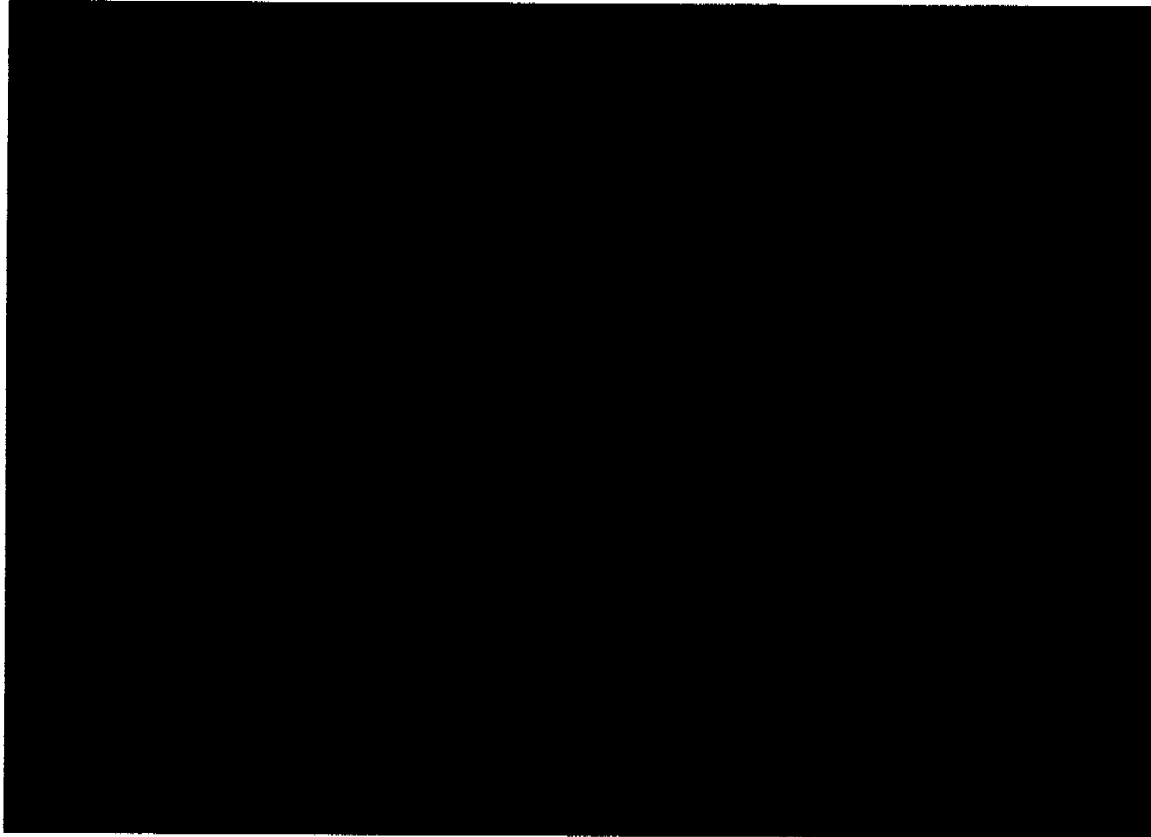
Figure 10

**E. Distribution**

The term "Distribution" refers to the record labels' costs of distributing manufactured product to retailers, one-stops (sub-distributors that buy in bulk from the majors and sell to stores that buy small quantities) and rack jobbers (independent category managers for mass merchants). It includes the costs of warehousing, freight, handling, bad debts, cash discounts to purchasers, and additional advertising and promotion payments to customers.

The distribution costs paid by the major record labels collectively during each of the years 1991-2005 are shown in Figure 11.





**Figure 11**

As RIAA Ex. M-201-DR and Figure 11 illustrate, the major record labels spent a total of [REDACTED] on distribution costs during the years 1991-2005, or an average of [REDACTED] per year. As shown in Figure 12 below, distribution costs ranged from [REDACTED] to [REDACTED] percent of the record labels' net sales revenue.

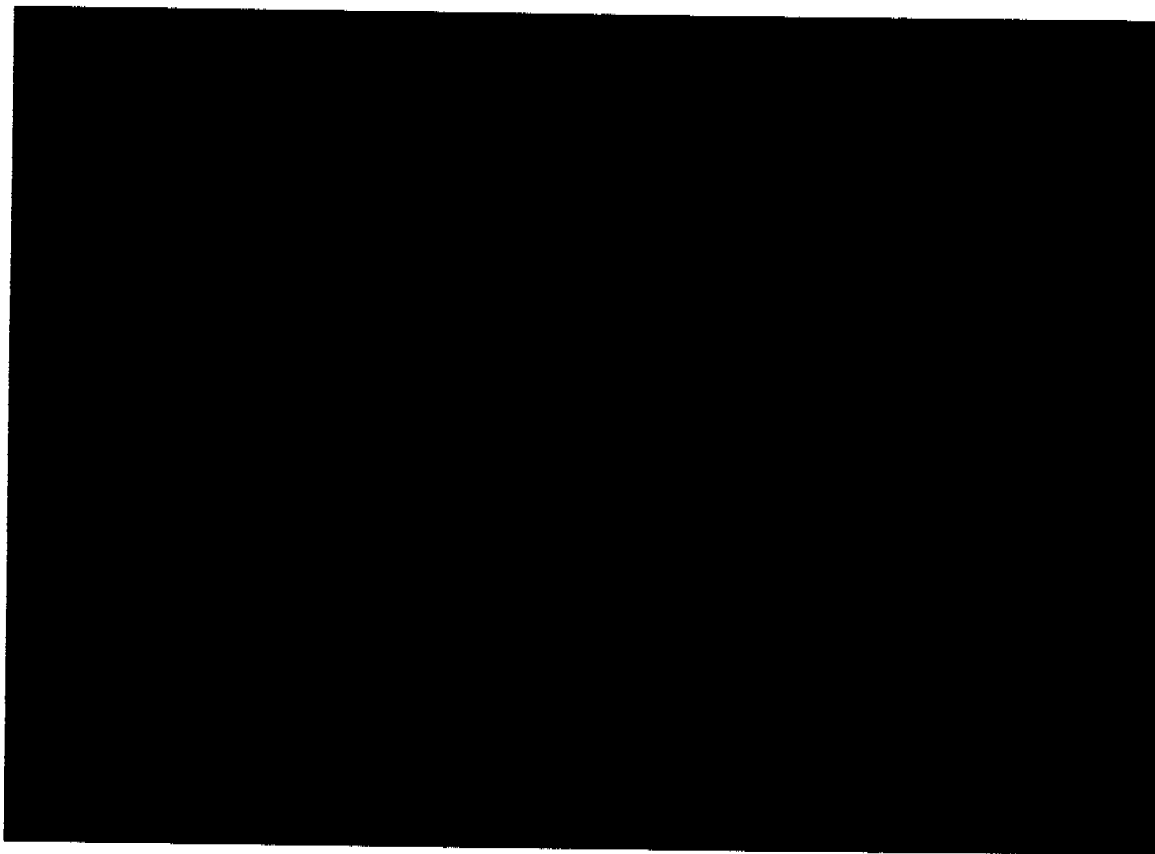
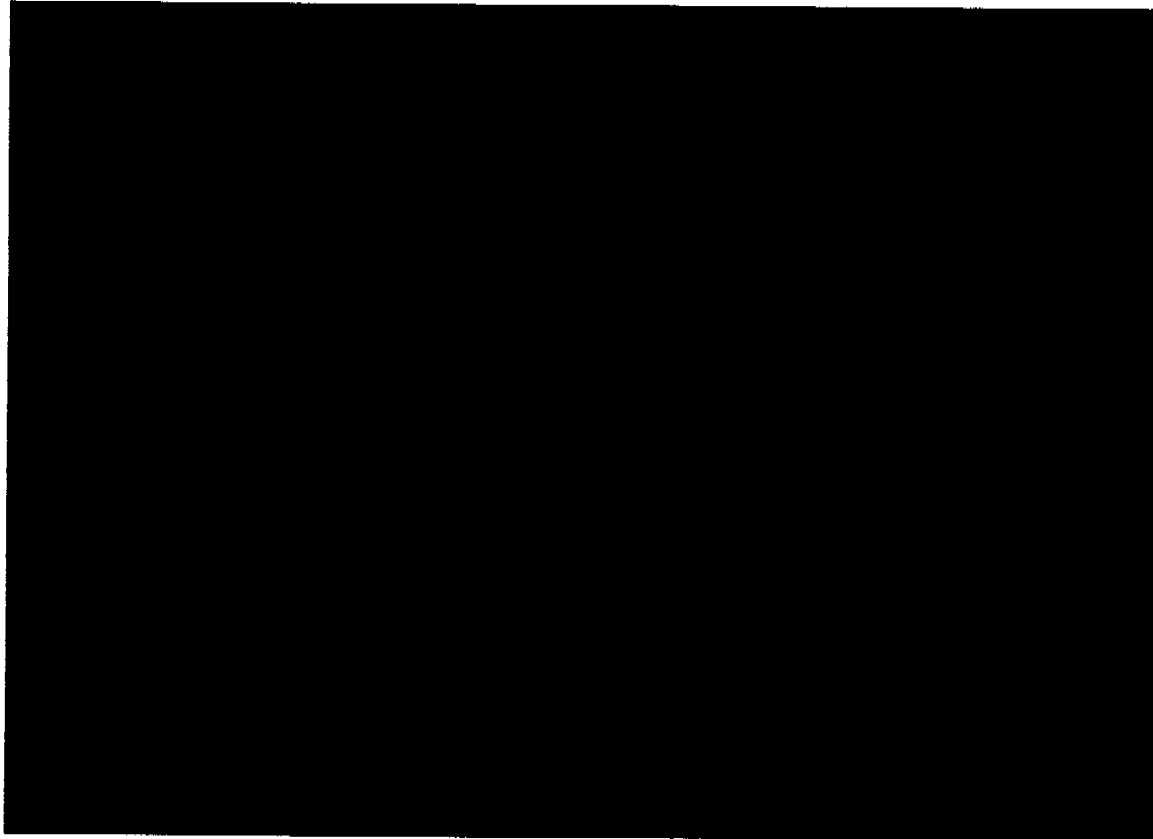


Figure 12

**F. Overhead**

The term “Overhead Costs” refers to the indirect costs of operating the record labels. It includes salaries, office space, utilities, and travel and entertainment expenses for record company personnel. These indirect costs include the in-house costs of working with artists, marketing recordings, and accounting and other administrative functions.

Overhead costs paid by the major record labels collectively during each of the years 1991-2005 are shown in Figure 13.



**Figure 13**

As RIAA Ex. M-201-DR and Figure 13 illustrate, the major record labels spent a total of [REDACTED] on overhead costs during the years 1991-2005, or an average of [REDACTED] per year. As shown in Figure 14 below, overhead costs ranged from [REDACTED] to [REDACTED] percent of the record labels' net sales revenue.

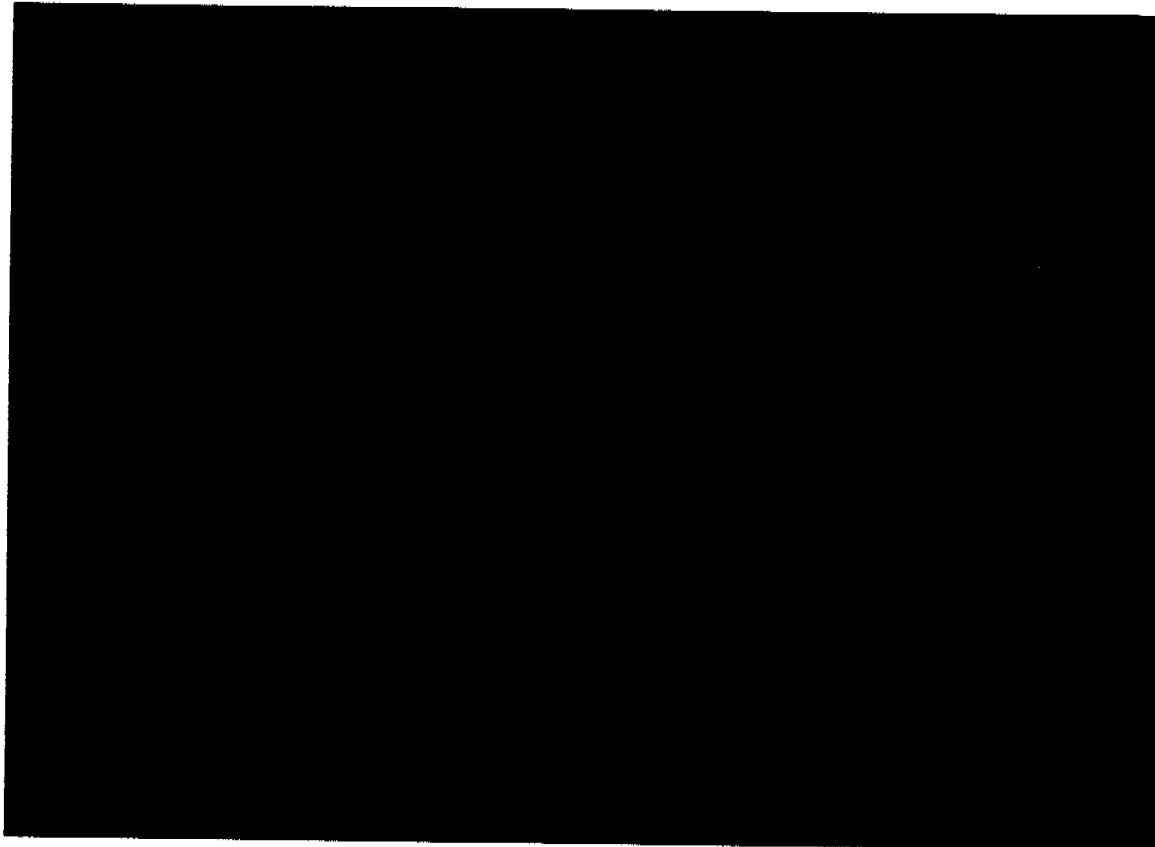
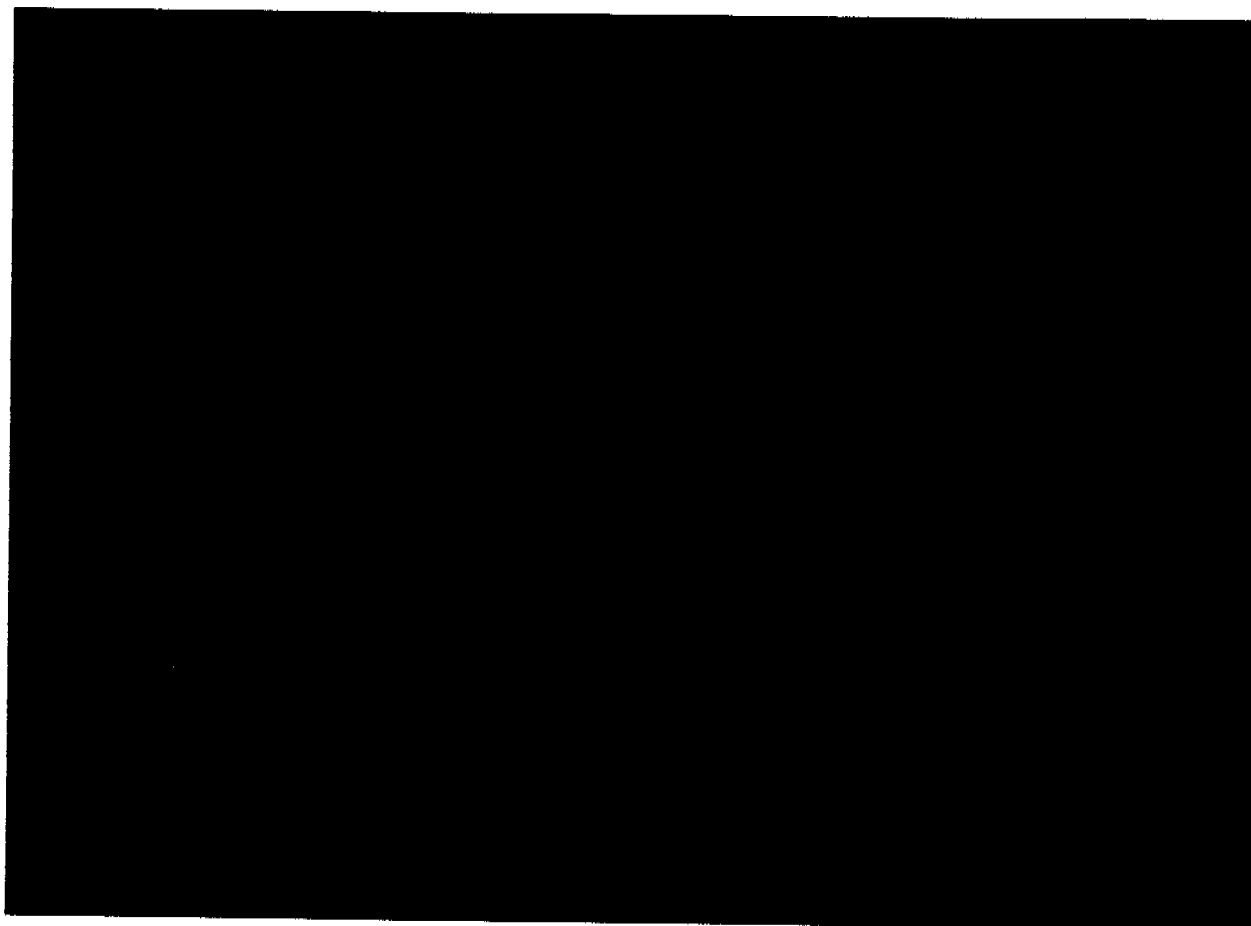


Figure 14

**G. Summary**

Total cost is the sum of mechanical royalties, artist royalties, advances and recording costs, direct marketing costs, manufacturing costs, distribution costs and overhead costs. The costs paid by the major record labels collectively during each of the years 1991-2005 are shown in Figure 15.



**Figure 15**

As RIAA Ex. M-201-DR and Figure 15 illustrate, the major record labels spent a total of [REDACTED] in costs during the years 1991-2005, or an average of [REDACTED] per year.

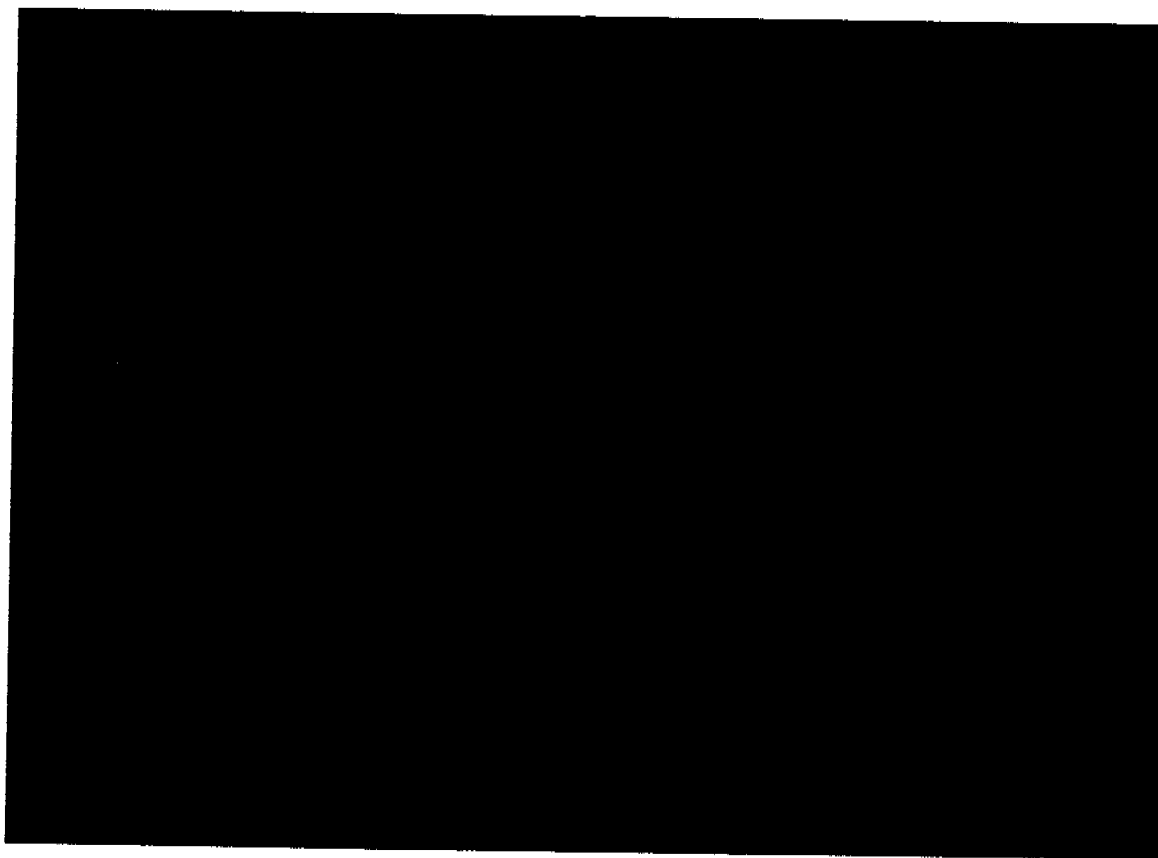
**II. Revenues**

In this section, I provide data on net sales revenue and net license income for the major record labels for the years 1991-2005.

**A. Net Sales Revenue**

The term "Net Sales Revenue" refers to record label income from domestic U.S. sales, including digital sales, after crediting the value of sound recordings returned unsold.

Figure 16 shows the net sales revenue for the majors for each year from 1991-2005.



**Figure 16**

As RIAA Ex. M-201-DR and Figure 16 illustrate, total net sales revenue for 1991-2005 was [REDACTED], and average yearly net sales revenue during this period was [REDACTED]. Digital sales revenue was [REDACTED] in 2004 and [REDACTED] in 2005.

**B. Net License Income**

The term "Net License Income" refers to licensing income which is principally from U.S. record clubs and foreign sales of domestic artists' music recordings, as well as from compilations such as soundtracks featuring different artists from different record labels. Artist royalties on licensed works are subtracted to reach the net income figure. There are no mechanical royalties incurred by the major record labels in connection with their net licensing income. Any mechanical royalties are paid by the licensee, such as the U.S. record club or the foreign seller.

Figure 17 shows net license income for the major record labels for each year from 1991-2005.



**Figure 17**

As RIAA Ex. M-201-DR and Figure 17 illustrate, total net license income for 1991-2005 was [REDACTED], and average yearly net license income during this period was [REDACTED].

**III. Comparison of Costs and Revenues**

Figure 18 shows total costs (the sum of mechanical royalties, artist royalties, advances and recording costs, direct marketing costs, manufacturing costs, distribution costs and overhead), net sales revenue and net licensing income.



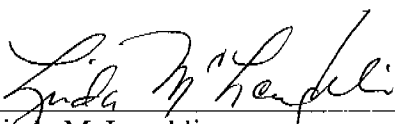
**Figure 18**

As RIAA Ex. M-201-DR and Figure 18 illustrate, the major record labels' collective total costs for 1991-2005 exceed their total net sales revenue.



For the 1991-2005 period, total costs amount to [REDACTED], total net sales revenue amounts to [REDACTED], and the excess of costs over net sales revenue is [REDACTED]. Only when net license income is included does total revenue exceed total costs. Net license income for 1991-2005 amounts to [REDACTED]. For the 1991-2005 period, total revenue exceeds total costs by [REDACTED]. Total costs exceed net sales revenue in each year 1991-2004 and total revenue (net sales revenue and net licensing income combined) exceeds total costs in each year 1991-2005.

I declare, under penalty of perjury, that the foregoing testimony is true and correct  
to the best of my knowledge.

  
\_\_\_\_\_  
Linda McLaughlin

Date: November 28, 2006

**Exhibits Sponsored by Linda McLaughlin**  
**(Restricted)**

<b>Exhibit Number</b>	<b>Description</b>
M-201-DR	Major Record Labels: Summary of Revenues and Costs for Domestic Sales, 1991-2005

## **Appendix 1**